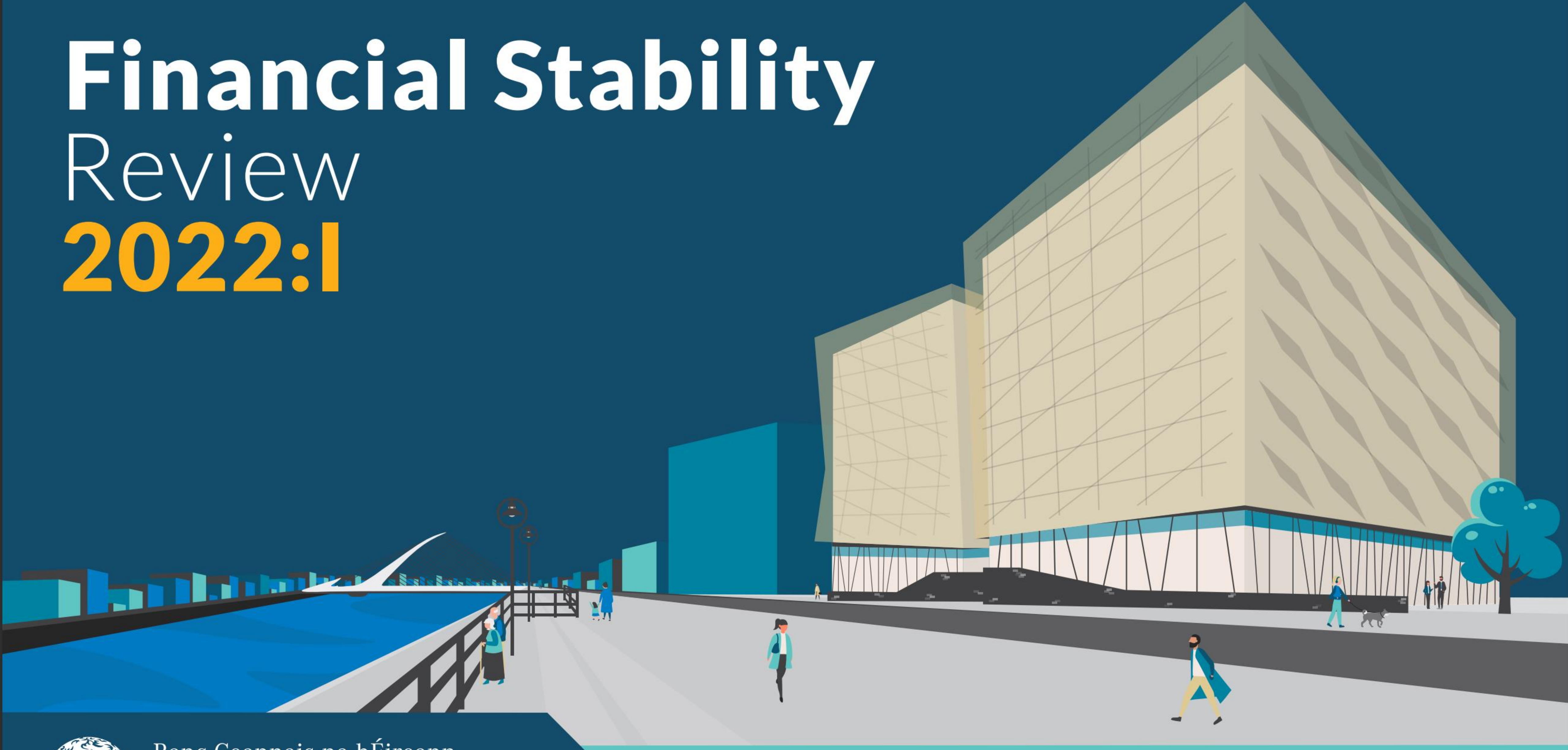
Financial Stability Review 2022:I



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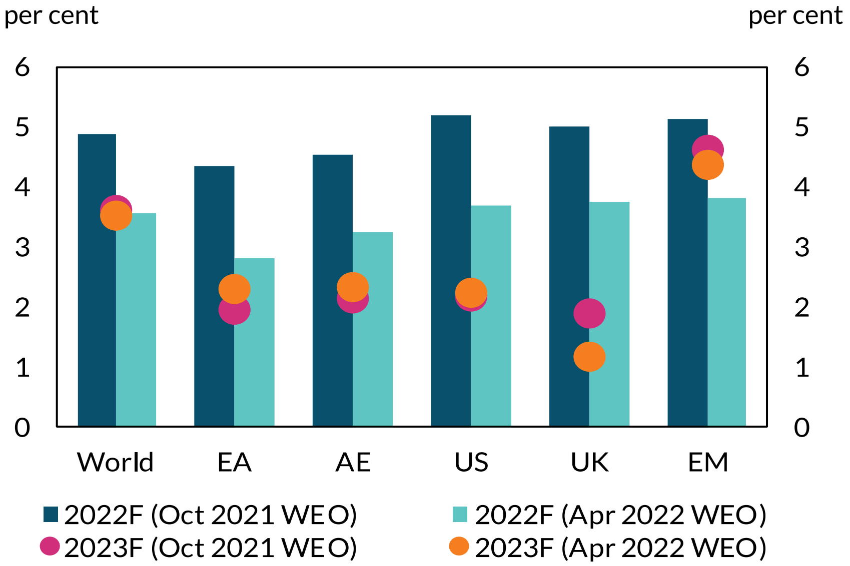
Main messages of the *Financial Stability Review*

Risks facing the financial system	• The pandemic-related shock has been dissipating on the back of the strong recovery, but medium-term risks facing the financial system have increased, amplified by the war in Ukraine.
Resilience of the financial system	• Rising inflation and interest rates will challenge some borrowers' finances, but resilience of borrower balance sheets improved over the past decade. Bank capital buffers robust and profitability improved.
Policies to safeguard financial stability	• Updated strategy for macroprudential capital buffers, building on domestic and international experience over the past decade, including COVID-19, and taking holistic perspective on bank capital. • Counter-cyclical capital buffer (CCyB) will be the main tool to safeguard resilience against macro-financial risks, including those stemming from the small and globalised nature of the Irish economy. • Gradually rebuilding CCyB as the risk environment has shifted. CCyB set at 0.5%, with a view to raising to 1.5%, which the Central Bank judges to be appropriate when risks are neither elevated, nor subdued.

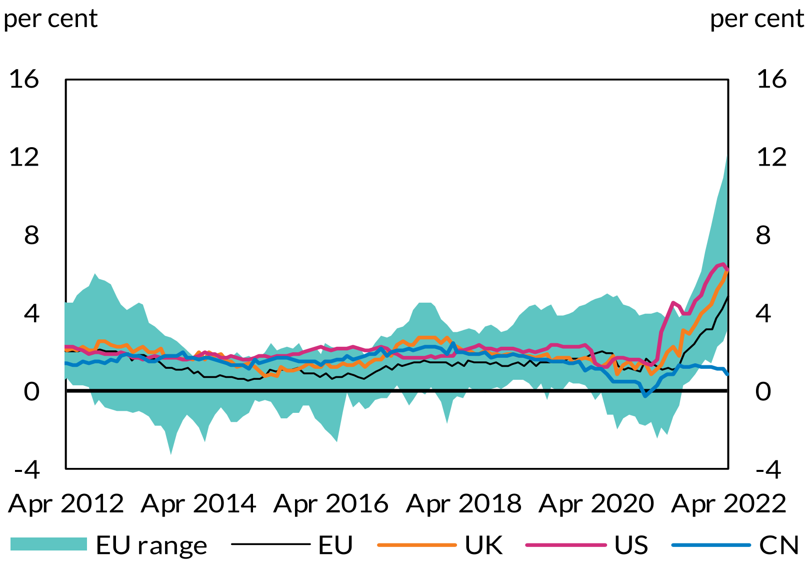
The strong global recovery from COVID has been disrupted by the war in Ukraine, while inflationary pressures have been building…

Following a robust recovery, the outlook for global growth has deteriorated recently



Source: IMF.
Note: WEO refers to the World Economic Outlook. The reference period in the brackets denotes the publication date of the forecasts. EA refers to euro area, AE refers to advanced economies, EM refers to emerging markets, F refers to forecasts.

In addition to the sharp rise in energy prices, non-energy inflation has continued to rise



Source: Eurostat and Bloomberg.
Notes: EU range refers to the spread between the largest and smallest annual change in inflation (excl. energy) of EU Member States. Last observation April 2022.

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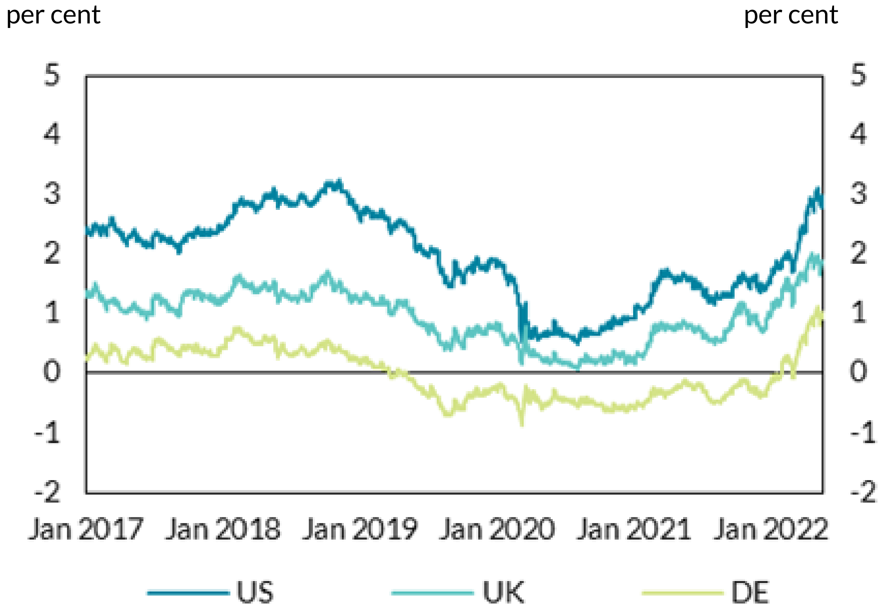
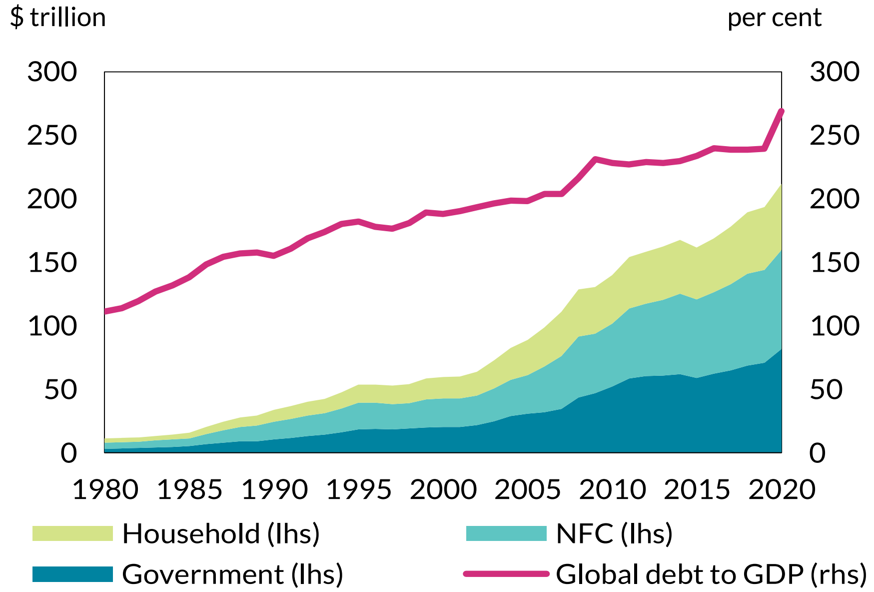
…the possibility of tighter than expected monetary policy raises risks around global asset valuations and indebtedness…

Expectations of tighter monetary policy have led to a sharp increase in bond yields



Source: Bloomberg and Central Bank of Ireland calculations.
Notes: Selected 10-year government bond yields. Last observation is 20 May 2022.

Levels of indebtedness at a global level are high from a historical perspective



Source: IMF Global Debt Database and Central Bank of Ireland calculations.
Notes: NFC refers to non-financial corporates. Last observation: 2020.

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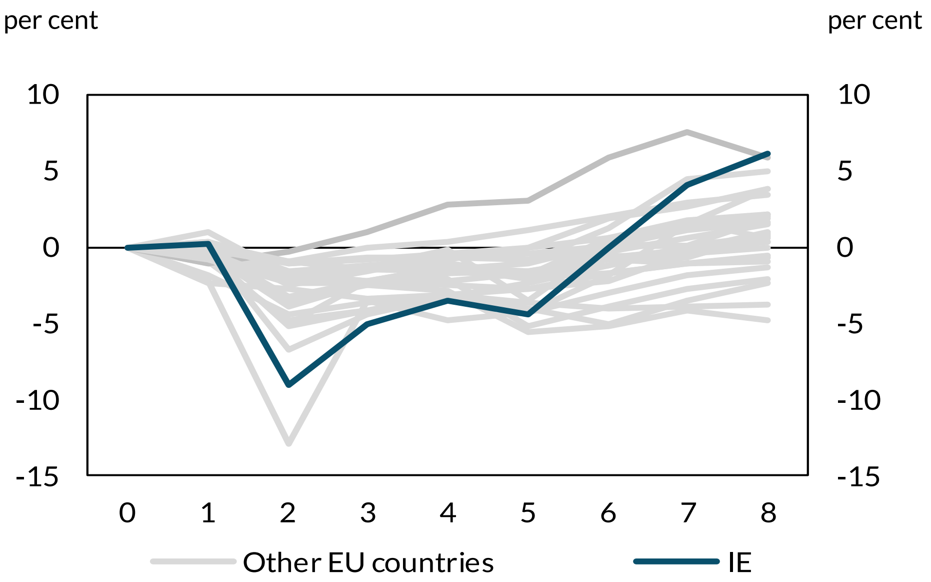
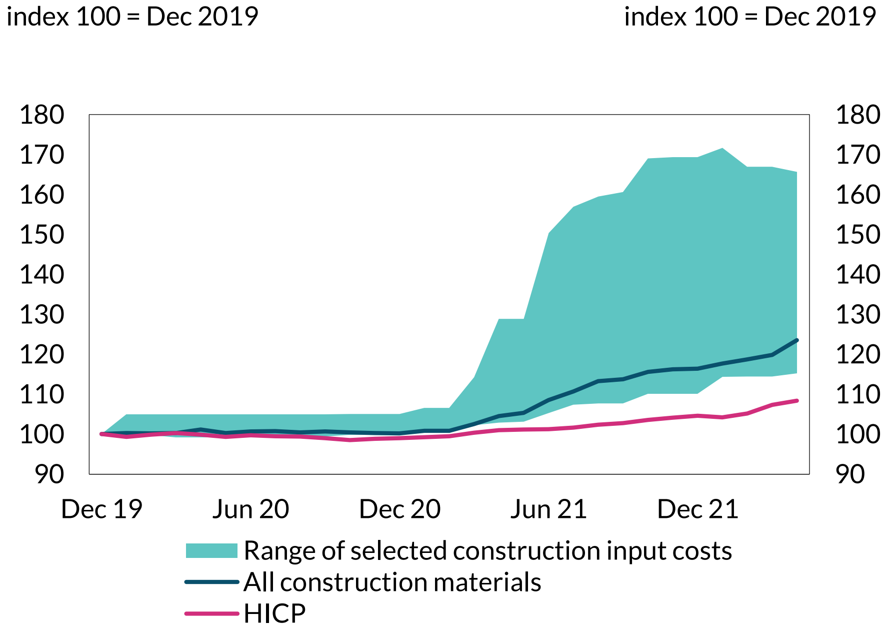
…the rebound in domestic economy activity post-COVID is leading to emerging sectoral capacity constraints.

The Irish labour market has experienced a more robust recovery than most European peers



Source: Eurostat.
Notes: Per cent change in total employment from pre-pandemic level (i.e. 2019Q4): Ireland and EU countries by quarter. Data cover the period 2019Q4 (quarter 0) to 2021Q4 (quarter 8).

Supply pressures are particularly evident in some sectors, such as construction



Source: CSO.
Notes: Selected construction input costs include: "Electrical fittings", "Insulation materials", "Structural steel and reinforcing metal", "Rough timber (including plain sawn)", "Copper" and "Cement". All construction materials refers to the "Wholesale Price Index (excluding VAT) for Building and Construction Materials" and therefore comprises a wider basket of construction materials than shown in the range of selected construction input costs. Last observation April 2022.

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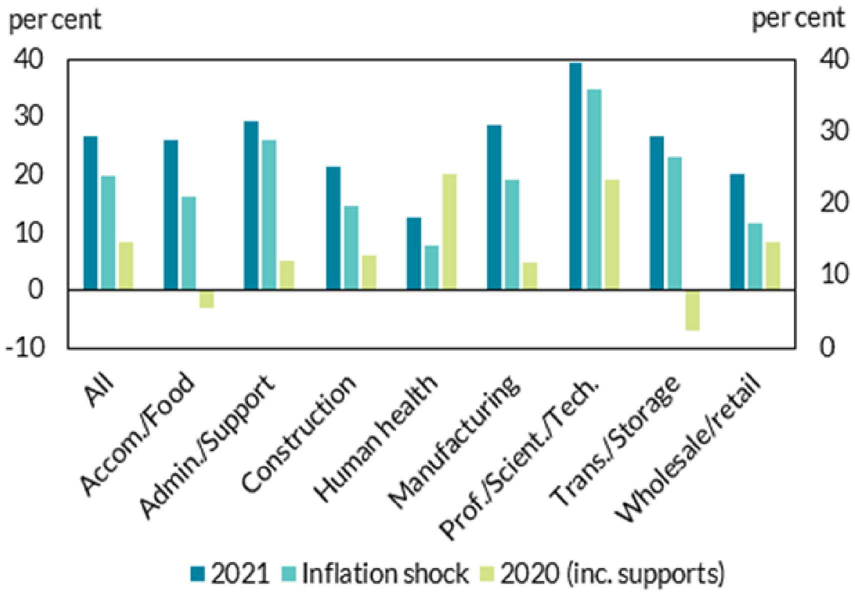
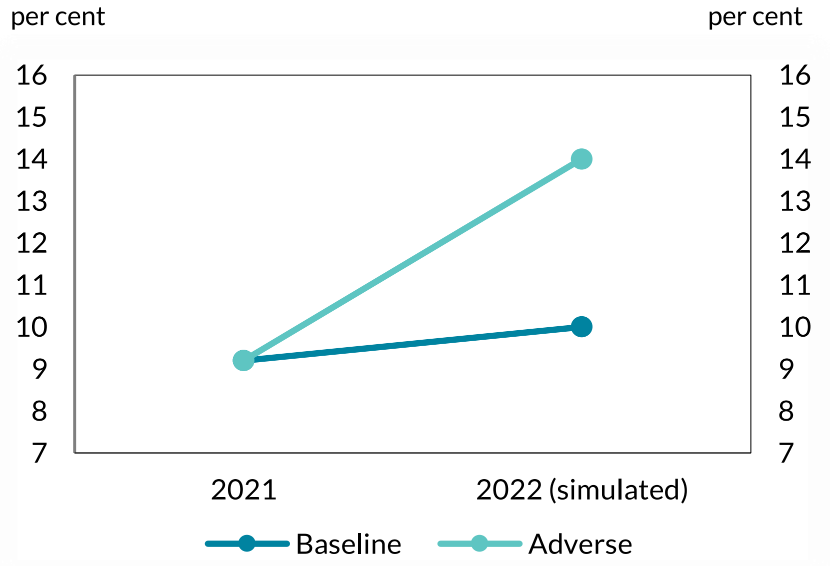
Inflation and rising rates will challenge some borrowers' finances, but resilience of balance sheets has improved over the past decade…

Inflation could erode SME profit margins, depending on price reactions



Source: Department of Finance Credit Demand Survey and CSO.
Notes: Average gross profit to turnover realised by SMEs in 2021 and adjusted for 30 per cent energy, 30 per cent purchases, 2.3 per cent wage cost inflation (consistent with the Central Bank's Quarterly Bulletin forecast), and a 2 per cent turnover increase by sector.

Estimated proportion of mortgage borrowers at risk, before and after the inflation shock



Source: Household Budget Survey and Central Bank of Ireland calculations.
Notes: Buffer = (After Tax Income – Mortgage Payment – Non-housing essential spending). Borrowers are defined as being "at risk" where [Buffer < 0.1*Mortgage Payment]. Estimate of essential spending is constructed by stripping out one-off expenditure on appliances, college fees, sport, holidays and other forms of leisure from total expenditures. Inflation in 2022 is assumed to be 5.5 per cent and 9.8 per cent in the baseline and adverse scenario, respectively. Income growth is assumed to be zero in the adverse scenario and 1.7 per cent and 2.3 per cent in the baseline scenario in 2021 and 2022, respectively.

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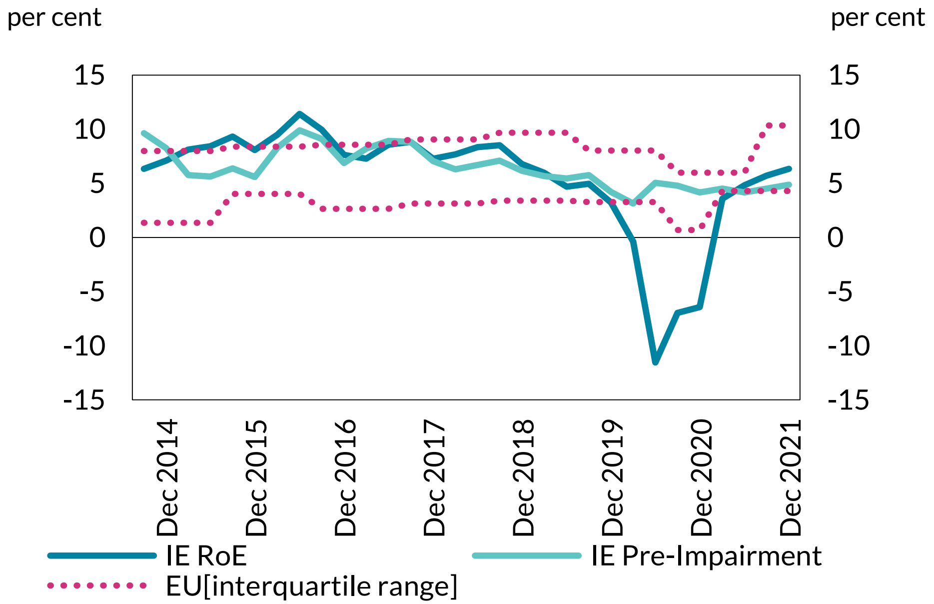
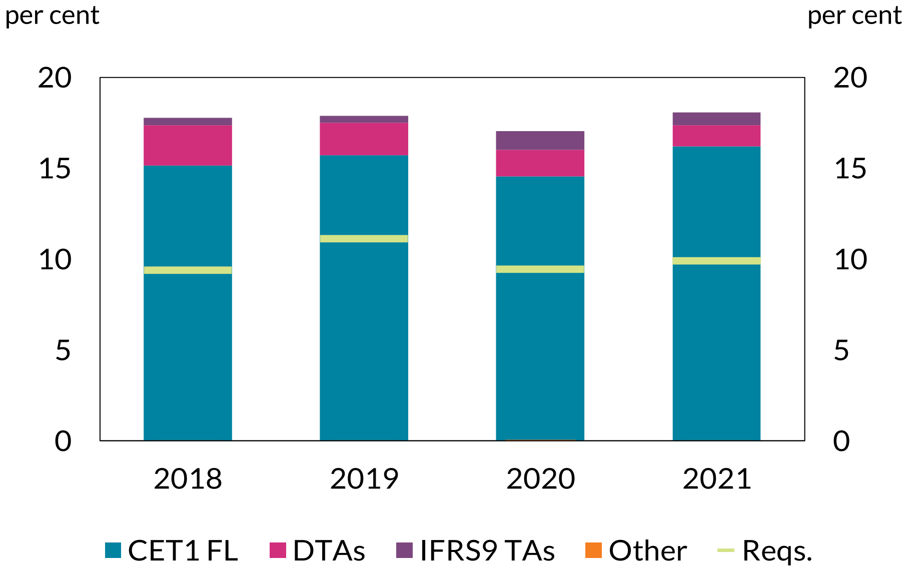
…the banking sector has returned to profits and capital ratios remain high, albeit expected to decline given transactions.

Bank profitability has returned to pre-pandemic levels, following losses during the pandemic



Source: Central Bank of Ireland and BankFocus.
Notes: "IE RoE" and "IE Pre-Impairment denotes the system-wide return on equity and pre-impairment scaled by total equity for AIB, BOI and PTSB. The dotted pink lines reflect the upper and low quartile for the return on equity among a sample of representative European banks.

CET1 ratios well above regulatory requirements, but expected to decline in the coming years



Source: Central Bank of Ireland
Notes: The chart shows the system-wide CET1 ratio for AIB, BOI and PTSB in addition to the overall capital requirements (Reqs.) and the contribution of the transitional arrangements, where "DTAs" denotes the CET1 adjustment from deferred tax assets and "IFRS9 TAs" denotes the CET1 adjustment due to IFRS9 transitional arrangements.

Updating our strategy around macroprudential buffers for banks

Why?

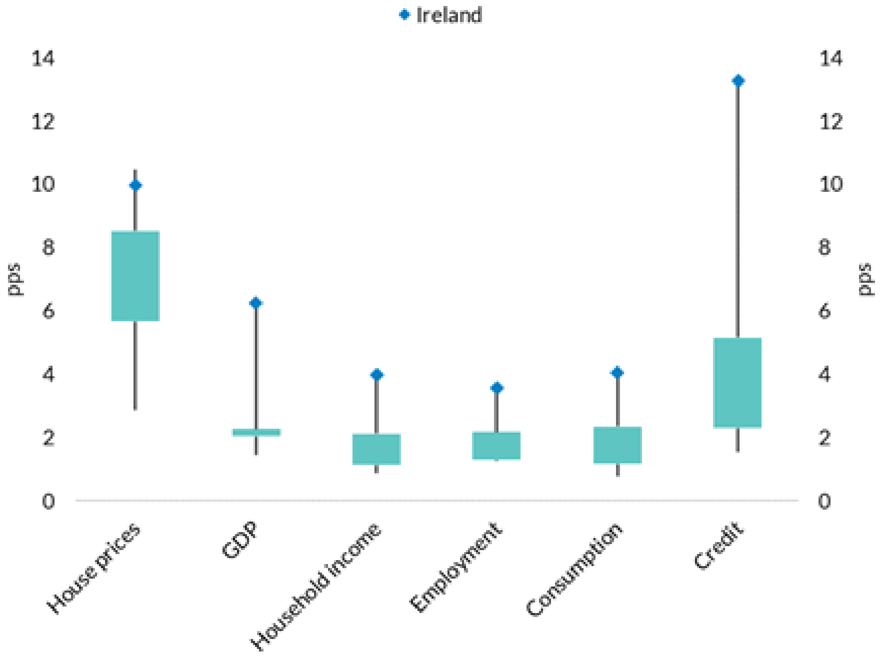
- Incorporate **lessons from domestic and international experience** over the past decade, including operation of buffers during the COVID-19 shock.
- Central Bank provided a with **new macroprudential instrument** under transposition of European legislation (Systemic Risk Buffer).
- Clarity over our strategy around macroprudential capital buffers **enhances transparency and accountability** and better enables firms to plan ahead.

How?

- Take a **holistic perspective around macroprudential capital**, including to account for the interactions between different macroprudential capital buffers.
- Consider the setting and implementation of macroprudential capital buffers, within the **wider context of the overall bank capital framework**.
- **Incorporate assessment of both macroeconomic benefits and macroeconomic costs** of different levels of bank capital.

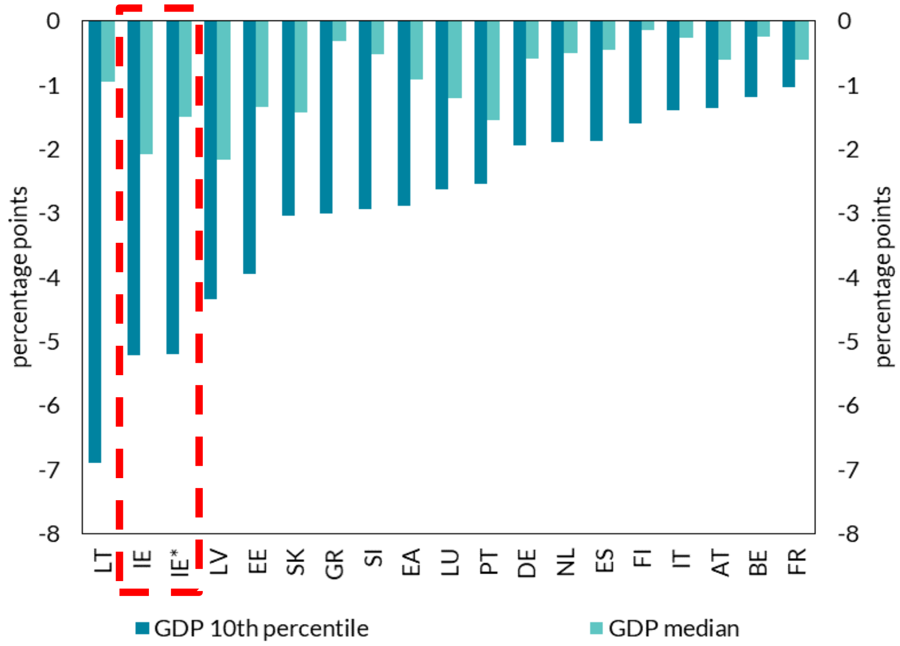
Macroprudential capital buffers in the specific Irish context

The small, highly globalised nature of the economy means that the domestic banking system is subject to greater degree of macroeconomic 'tail risk'



Source: Central Bank of Ireland calculations
Notes: Volatility is the standard deviation of annual growth rates in the series examined (1980Q2-2018Q2). For Household Income and Credit to NFC 1997Q2-2018Q2. GDP is replaced with modified GNI* for Ireland.

Given its openness, Ireland is particularly sensitive to developments in the rest of the world, including shocks to global financial conditions



Source: Beutel, J., Emter, L., Metiu, N., Prieto, E. and Schueler, Y., (2020), "Dilemma or Trilemma? Evidence from the international transmission of US financial shocks to downside risks to growth", mimeo.
Notes: 4 quarter sum of the IRF of log difference in GDP growth at the 10th percentile or median to a one standard deviation increase in US EBP. The underlying Bayesian Quantile VAR model also includes CPI and short-term interest rates and two lags of all variables and is estimated for the period 1980Q1 to 2018Q4, given data availability for individual countries. The variables are ordered as follows: EBP, GDP, CPI, interest rates. IE* denotes results for GNI*.

Updated strategy: instrument composition

- **The Central Bank will use the CCyB as the primary macroprudential buffer to safeguard resilience against macro-financial risks**
  - The Central Bank will rely on the CCyB to safeguard resilience against macro-financial risks, including those stemming from the small and globalised nature of the Irish economy. The Central Bank no longer intends to activate the SyRB for this risk.
- **The Central Bank will continue to use the O-SII buffer to hold systemically-important institutions to higher capital standards**
  - Systemically-important institutions pose greater risks to the economy and financial system if they fail. Proportionate with their increased contribution to system-wide risks, O-SII buffers require additional resilience.
- **Overall, the CCyB and the O-SII buffers will be the two macroprudential tools that the Central Bank expects to be employing actively and reviewing on a regular basis**
  - Other macroprudential capital tools in legislation (SyRB, macroprudential measures in relations to risk weights and Article 458) remain part of the Central Bank's toolkit and are available should additional risks require mitigation.

Updated strategy: approach to the CCyB

- **The Central Bank will build the CCyB rate to 1.5 per cent , when risk conditions are deemed to be neither elevated, nor subdued.**
  - Strategy more robust to inherent uncertainty in assessing the degree of risk facing the banking system and the time lags in implementing the CCyB.
  - By moving early in the cycle, the Central Bank has scope to implement policy changes in a gradual manner, where necessary and appropriate, minimising potential unwanted impacts on the real economy.

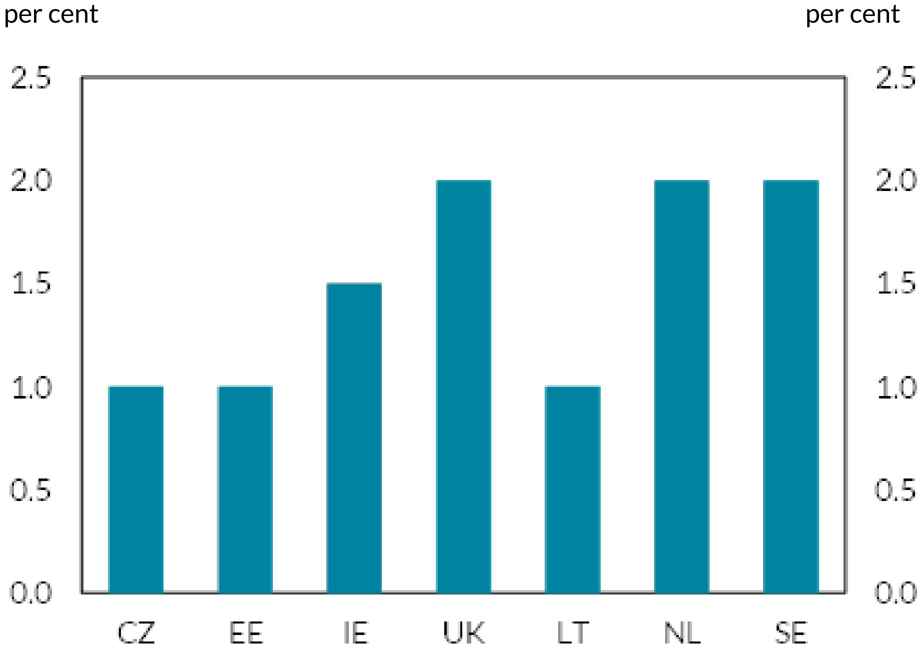
- **If risk conditions build to more elevated levels, the CCyB rate is expected to increase above 1.5 per cent.**
  - Objective of the CCyB is to build resilience of the banking system in line with the magnitude of risks it faces.
  - Risk conditions relate to developments in credit, the domestic economy, asset prices, risk appetite and global conditions.

- **The CCyB rate would be reduced or released in light of a materialisation of cyclical systemic risk or a downturn.**
  - This facilitates the banking system to absorb losses and maintain the supply of lending to the economy. This is consistent with its objective to mitigating macro-economic risks associated with pro-cyclical bank lending behaviour during a downturn.

Inputs informing the Central Bank's strategy

- **Assessment of macroeconomic benefits and costs of bank capital**
  - Tier 1 capital of 14-18% serves as an overarching reference for guiding the Bank's use of macroprudential buffers, when risks are neither subdued nor elevated.
  - Taking into account other prudential requirements, a CCyB at 1.5% brings overall capital demand into the lower part of this range.
- **Macroprudential stress test of the banking system**
  - Adverse scenario reflecting judgement around risk environment. Significant shock, but not as severe as the financial crisis, given the smaller degree of imbalances now. If risks were to grow, scenario would become more severe.
- **Experience during the COVID-19 shock**
  - Benefits of releasable macroprudential capital buffers to better support lending to the economy in the face of adverse shocks.
- **Approaches taken in other jurisdictions**
  - A number of jurisdictions are setting a positive CCyB rate when risks are neither subdued nor elevated.

A number of countries have adopted strategies whereby a positive CCyB rate would be set in normal risk conditions

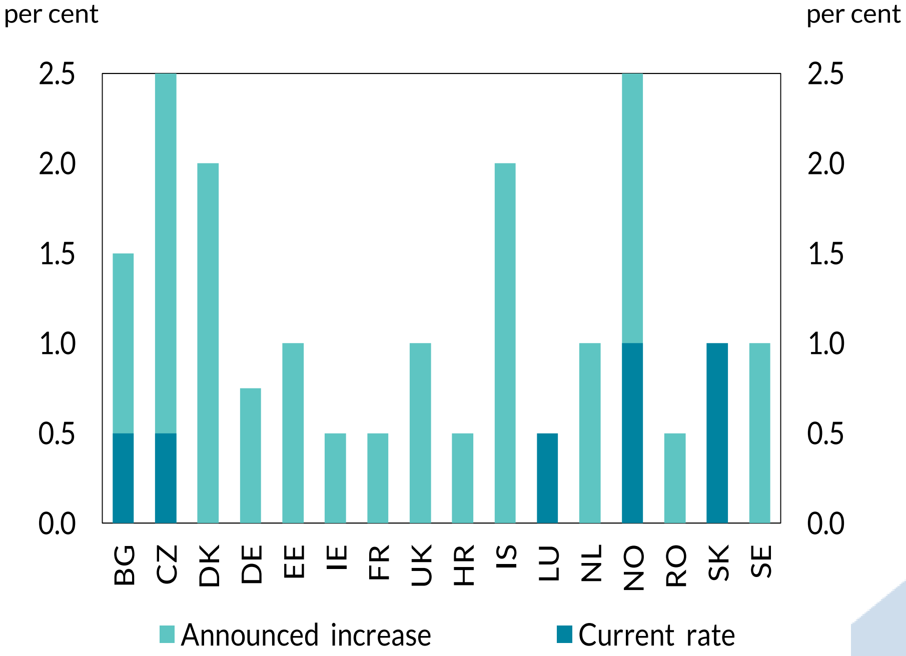


Source: Czech National Bank, Danish Risk Council, Eesti Pank, Bank of England, Lietuvos Bankas, De Nederlandsche Bank, Norges Bank, Sveriges Riksbank.
Notes: In addition to the above, authorities in DK and NO have the stated intention of setting a positive CCyB rate early in the cycle but do not have an explicit reference rate in this regard.

The latest CCyB decision

- **Consistent with previous guidance provided by the Central Bank, CCyB increased to 0.5 per cent**
  - Increase is consistent with the revised strategy and reflects the shift in the risk environment since the depths of the pandemic shock.
- **The move to 0.5 per cent is a first step in moving to a rate of 1.5 per cent, the CCyB rate the Central Bank intends to set when risk conditions are neither elevated nor subdued.**
  - Given the current outlook, a 1.5 % rate would be expected to be announced in mid-2023.
- **The path for the CCyB will ultimately be state-dependent and the speed of build-up would depend on evolution of expected macro-financial developments.**
  - As in the case of the COVID-19 shock, should there be a crystallisation of risks, the Central Bank could reduce the CCyB rate with immediate effect.

Reflecting the evolving risk environment in many countries, the CCyB is being built up across Europe



Source: ESRB, Systemic Risk Council, Banque de France, Bank of England, De Nederlandsche Bank. .

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Risk, Resilience, Policy

Pandemic-related risks reducing, but medium-term risks have been building & are amplified by the war in Ukraine.

Risks from pronounced slowdown in global growth & persistent inflation

Vulnerabilities in global financial markets remain

Emerging cyclical vulnerabilities domestically & significant capacity constraints in some sectors

Risk, **Resilience**, Policy

Inflation will pose challenges, but borrowers & lenders have substantial resilience to absorb shocks.

Businesses continue to recover from the pandemic

Inflation poses cost of living & debt servicing challenges

Bank profitability improved, challenges remain

Risk, Resilience, **Policy**

Updated strategy for macroprudential capital announced.

CCyB to reflect risks stemming from the small, globalised nature of the Irish economy

Reflecting shift in risk environment, CCyB being set at 0.5%

CCyB to be built up to 1.5% when risks neither elevated nor subdued